

Testimony of

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State of Michigan

The Subprime Bust and the One-Page Mortgage Disclosure

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Mr. Chairman, Vice Chairmen Sanborn and Hunter, and members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a Resident Fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I spent 35 years in banking, including 12 years as President and CEO of the Federal Home Loan Bank of Chicago, and am a Past President of the International Union for Housing Finance. I have both experienced and studied many credit cycles, of which the housing and subprime mortgage boom and bust is the latest example. Before all that, I grew up in Michigan, in the City of Detroit, graduating from Redford High School.

The deflation of the housing bubble and the subprime mortgage bust is, as everyone now knows, the biggest financial issue of the year, and nowhere more so than in Michigan. I will address two aspects of this issue: understanding the fundamental pattern in which we are caught; and making sure future borrowers are better equipped to protect themselves than those of today.

The severe problems of all the industries involved in housing and mortgage finance, as well as of a great many mortgage borrowers, can best be understood as the deflation of a classic asset bubble. The boom is always marked by rapid and unsustainable asset price increases, inducing and fueled by a credit overexpansion marked by unwise optimism, which leads to unwise credit decisions on the part of both lenders and borrowers. The inevitable bust follows with defaults, losses and a credit contraction. We are in the midst, and by no means near the end, of the contraction.

American residential mortgages represent the largest credit market in the world, and residential real estate is a huge asset class and component of household wealth. The

negative effects of the deflating bubble on macroeconomic growth are sizeable and significant—some forecasters believe negative enough to cause a recession, which will in turn worsen the mortgage credit problems.

Among possible political responses are temporary programs to bridge and partially offset the impact of the bust, and to reduce the risk of a housing sector debt deflation or self-reinforcing downward spiral.

We can also take long term steps to fundamentally improve the functioning of the mortgage market. Today I will focus on a very simple but powerful proposal, which has been introduced into both houses of the U.S. Congress, passed as a local ordinance in by the Washington, DC Council, and could be used at a state level: a one-page mortgage disclosure which tells borrowers what they really need to know about their mortgage loan in a clear and straightforward way. This would both better equip borrowers to protect themselves and make the mortgage market more efficient.

1. Understanding the Fundamental Pattern

Needless to say, the unsustainable expansion of subprime mortgage credit and the great American house price inflation of the new 21st century are both over. Former enthusiasm at rising home ownership rates and financial innovation (now a little hard to remember) have been replaced by an international credit market panic, layoffs, closing or bankruptcy of more than a hundred subprime lenders, still accelerating delinquencies and foreclosures, a deep recession in the homebuilding industry, tens of billions of dollars of announced losses by financial firms, tightening or disappearing liquidity, increasingly pessimistic forecasts, and of course, recriminations.

A few months ago, typical estimates of the credit losses involved were about \$100 billion. Then they grew to \$150 billion, a number Federal Reserve Chairman Bernanke recently cited, and which I believe to be a reasonable estimate. Other forecasts have the total losses at \$250 billion, \$300 billion, and even \$400 billion—well, uncertainty is high. Those are the losses for the lenders; for the borrowers, as you all know only too well, rising foreclosures are an obvious social and political issue.

All these elements display the classic patterns of recurring credit overexpansions and their aftermath, as colorfully discussed by students of financial cycles like Charles Kindleberger, Walter Bagehot and Hyman Minsky. Such expansions are always based on optimism and the euphoric belief in the ever-rising price of some asset class—in this case, houses and condominiums. This appears to offer a surefire way for lenders, investors, borrowers and speculators to make money, and indeed they do, for a while. As long as prices always rise, everyone can be a winner.

A good example of such thinking was the 2005 book by an expert housing economist entitled, Are You Missing the Real Estate Boom? Why the Boom Will Not Bust and Why Property Values Will Continue to Climb Through the Rest of the Decade.

This time, we had several years of remarkably rising house prices—the greatest U.S. house price inflation ever, according to Professor Robert Shiller of Yale University. The total value of residential real estate about doubled between 1999 and 2006, increasing by \$10 trillion. The great price inflation stimulated the lenders, the investors, the borrowers and the speculators. If the price of an asset is always rising, the risk of loans seems less and less, even as the risk is in fact increasing, and more leverage always seems better.

A key point is that in the boom, many people experience financial success. This so-far successful speculation is extrapolated. Subprime borrowers could get loans to buy houses they would otherwise be unable to and benefit from subsequent price appreciation. A borrower who took out a very risky 100% LTV, adjustable rate mortgage with a teaser rate to buy a house which subsequently appreciated 30% or 40% now had substantial equity and a successful outcome as a result of taking risk.

Should people be able to take such risks if they want to? Yes, but they should have a clear idea of what they're doing.

Of course, we know what always happens sooner or later: the increased risk comes home to roost, prices fall, and there is a hangover of defaults, failures, dispossession of unwise or unlucky borrowers, revelations of fraud and swindles, and the search for the guilty. You would think we would learn, but we don't. Then come late-cycle political reactions.

With regard to the last point, since 1970 we have had the Emergency Home Finance Act of 1970, the Emergency Housing Act of 1975, the Emergency Housing Assistance Act of 1983, and the Emergency Housing Assistance Act of 1988. (I do not count the Hurricane Katrina Emergency Housing Act of 2005, a special case.) Kindleberger estimated that over the centuries, financial crises recur about once a decade on average, and so apparently do emergency housing acts. It seems probable to me that, given the current problems, this fall or winter will bring an emergency housing act of 2007 or 2008. Indeed, the "Emergency Home Ownership and Mortgage Equity Protection Act of 2007" has been introduced in to the Congress.

A year ago, it was common to say that while house prices would periodically fall on a regional basis, they could not on a national basis, because that had not happened in the large U.S. market since the Great Depression. Well, now house prices are falling on a national basis, as measured by the S&P/Case-Shiller national index.

House sales have dropped steeply, and for-sale inventories of new and existing houses and condominiums are high. At the same time, rising mortgage delinquencies and defaults, along with the collapse of funding through securitization, have caused lenders to drop subprime products or exit the business altogether and generally raise credit standards. The Chairman of Countrywide Credit has announced, "We are out of the subprime business." Sharply reduced mortgage credit availability reduces housing demand.

With excess supply and falling demand, it is not difficult to arrive at a forecast of further drops in house prices. The recent Goldman Sachs housing forecast, pointing out “substantial excess supply” and that “credit is being rationed,” projects that average house prices will fall 7% a year through 2008. This is along with projected falling home sales and housing starts.

Professor Shiller has suggested that this cycle could see “more than a 15% real drop in national home price indices.” Certainly a return to long term trends in house values would imply a significant adjustment.

The Bank of America’s current forecast has nominal house prices falling 15% (real prices over 30%) over four years, having started this year and not bottoming until 2011.

Thus the “HPA” or house price appreciation of credit models has now become “HPD”—house price depreciation.

The June 30, 2007 National Delinquency Survey of the Mortgage Bankers Association reports a total of 1,090,300 seriously delinquent mortgages. Serious delinquency means loans 90 days or more past due plus loans in foreclosure. Of the total, 575,200 are subprime loans. Thus subprime mortgages, which represent about 14% of mortgage loans, are 53% of serious delinquencies.

The survey reports 618,900 loans in foreclosure, of which 342,500 or 55% are subprime.

The ratio of subprime loans in foreclosure peaked in 2002 at about 9%, compared to its June 30 level of 5.5%. Seriously delinquent subprime loans peaked during 2002 at 11.9%, compared to 9.3%. These second-quarter ratios are not as bad as five years ago, but they are still rising.

A systematic regularity of mortgage finance is that adjustable rate loans have higher defaults and losses than fixed rate loans within each quality class. Thus we may array the June 30, 2007 serious delinquency ratios as follows:

Prime fixed	0.67%	Prime ARMs	2.02%
FHA fixed	4.76%	FHA ARMs	6.95%
Subprime fixed	5.84%	Subprime ARMs	12.40%

The particular problem of subprime ARMs leaps out of the numbers. The total range is remarkable: the subprime ARM serious delinquency ratio is over 18 times that of prime fixed rate loans.

Mortgage finance has some reliable systematic risk factors. The mortgage boom had all the systemic risk factors operating together:

- Subprime loans have higher defaults and losses than prime loans.

- Adjustable rate loans of all kinds have higher defaults and losses than fixed rate loans.
- High loan-to-value (LTV) loans have higher defaults and losses than low LTV loans.
- Low documentation loans have higher defaults and losses than standard documentation loans.
- Loans for investment properties have higher defaults than loans for owner-occupied houses.

The subprime mortgage lenders knew all these statements were true, but the risk acceleration of the boom outstripped the expectations of their models. As Moore's Law of Finance states, "The model works until it doesn't."

A central problem is that during the boom the subprime market got very much larger than it used to be. In the years of credit overexpansion, it grew to \$1.3 trillion in outstanding loans, up over 8 times from its \$150 billion in 2000. So the financial and political impact of the subprime level of delinquency and foreclosure is much greater than in earlier years.

But for Michigan, it is not only a subprime problem. Michigan's serious delinquency rate for all mortgage loans is 4.61%, almost twice the national average of 2.47%. This reflects the employment problems of the domestic auto industry, on top of the housing deflation, as is also the case for the neighboring high-delinquency states of Ohio and Indiana.

Michigan's serious delinquency rates are more or less double the national average in all mortgage loan categories, with the June 30 comparisons as follows:

	<u>Michigan</u>	<u>U.S.</u>	<u>Michigan/U.S.</u>
Subprime ARMs	21.08%	12.40%	1.7X
FHA ARMs	13.78%	6.95%	2X
FHA fixed rate	10.75%	4.76%	2.3X
Subprime fixed rate	9.47%	5.84%	1.6X
Prime ARMs	4.65%	2.02%	2.3X
Prime fixed rate	1.34%	0.67%	2X

For the country as a whole, fixed rate FHA loans have a serious delinquency rate similar to that for fixed rate subprime loans. This is also true for Michigan, which also has the highest FHA serious delinquency rate of any state.

The American residential mortgage market has about \$10 trillion in outstanding loans. Residential real estate is a huge asset class, with an aggregate value of about \$21 trillion, and is of course the single largest component of the wealth of most households.

A 15% average house price decline would mean a more than \$3 trillion loss of wealth for U.S. households, which would be especially painful for those who are highly leveraged. It would certainly put a crimp in getting cash to spend through cash-out refinancing and home equity loans.

The deflation of a bubble centered on such large stocks of debt and assets always causes serious macroeconomic drag. Housing busts have typically translated into recessions. It goes without saying that the current bust has already been and will continue to be a significant negative for economic growth. Moody's recently forecast that the "unexpectedly steep and persistent downturn" in the mortgage and housing sector would last until 2009.

At an AEI conference last March, my colleague Desmond Lachman predicted that the economic impact of the housing problems would be much worse than was generally being said at the time, including what he considered the overoptimistic view of the Federal Reserve, and that they would become a major political issue. These were certainly good calls.

Large losses from the deflating housing and mortgage bubble have already happened and must unavoidably work their way through the financial and economic system. Reductions in household wealth and tighter credit constraints on consumers might be enough to turn consumption growth negative and cause a recession.

This would be, my colleague John Makin has suggested, "the price we pay" for the housing bubble.

2. A Simple Proposal for Fundamental Improvement: The One-Page Form

The mortgage market, like all financial markets, is constantly experimenting with how much risk there should be. The subprime mortgage boom obviously overshot on risk creation; lenders, borrowers and the economy are now paying the price. "Risk," as an old boss of mine used to say, "is the price you never thought you'd have to pay."

Should ordinary people be free to take a risk in order to own a home, if they want to? Yes, provided they understand what they are getting into. (This is a pretty modest risk, to say the least, compared to those our immigrant and pioneer ancestors took, such as my great-grandfather, heading out to his homesteaded farm in Michigan.)

Should lenders be able to make risky loans to people with poor credit records, if they want to? Yes, provided they tell borrowers the truth about what the loan obligation involves in a straightforward, clear way.

A market economy based on voluntary exchange and contracts requires that the parties understand the contracts they are entering into. A good mortgage finance system requires that the borrowers understand how the loan will work and how much of their income it will demand.

Nothing is more clear than that the current American mortgage system does not achieve this. Rather it provides an intimidating experience of being overwhelmed and befuddled by a huge stack of documents in confusing language and small type presented to us for signature at a mortgage closing. This complexity results from legal and compliance requirements; ironically, past regulatory attempts to insure full disclosure have made the problem worse. This is because they attempt full, rather than relevant, disclosure.

Trying to describe 100% of the details in legalese and bureaucratese results in essentially zero actual information transfer to the borrower. The FTC recently completed a very instructive study of standard mortgage loan disclosure documents, concluding that “both prime and subprime borrowers failed to understand key loan terms.”

Among the remarkable specifics, they found that:

“About a third could not identify the interest rate”

“Half could not correctly identify the loan amount”

“Two-thirds did not recognize that they would be charged a prepayment penalty”
and

“Nearly nine-tenths could not identify the total amount of up-front charges.”

As the events of the current bust have demonstrated, this problem is especially important in, though by no means limited to, the subprime mortgage market.

To help address these shortcomings of the mortgage market which are evident, I believe a new, superior disclosure approach is needed. The key is to realize that complex, lengthy statements in regulatoryese and legalese do not achieve the goal. Moreover, the simple, clear disclosure should be focused on the financial impact on the borrower, not on the financial instruments.

The superior strategy is to equip borrowers to protect themselves by requiring short, simple and clear disclosures of the key mortgage loan terms and their relation to household income.

Thus I propose there should be a required one-page form which gives the essentials of the loan and its monthly cost, which must be given to every mortgage borrower well before closing.

A good mortgage lender wants a borrower who understands how the loan will work, including any possible future interest rate increases and prepayment penalties. The total monthly obligation needs to be put clearly in the context of the borrower's income.

To have informed borrowers who can better protect themselves, the key information must be simply stated and clear, in regular-sized type, and presented from the perspective of what commitments the borrower is making and what that means relative to household income. The borrowers can then “underwrite themselves” for the loan. They have a natural incentive to do so—and can if they have the relevant intelligible, practical information.

The one-page form should include key underwriting concepts, including the borrower's income and housing expense ratio, as well as principal loan terms. The “housing expense ratio” means the sum of the monthly interest payment, principal payment, property tax, and house insurance premium, expressed as a percent of the borrower's monthly income. This should be shown for both the initial interest rate and the fully-indexed interest rate. In typical types of subprime loans, as has become so painfully obvious, the fully-indexed expense ratio can be a remarkably larger burden than the initial or “teaser” rate suggests.

I have called the one-page form, “Basic Facts About Your Mortgage Loan.” With it are brief explanations of the mortgage vocabulary and some avuncular advice for borrowers. Borrowers should receive it from the lender in time to ensure understanding and the ability to make a decision to seek alternatives. A copy of the proposed form accompanies this testimony, as well as a copy of a Washington Post editorial recommending it.

I believe mandatory use of this form would help achieve the required clarity, make borrowers better able to protect themselves by understanding what the mortgage really means to them, and at the same time would promote a more efficient mortgage finance system. This seems to me a completely bipartisan idea, which should be implemented as a fundamental reform, whatever else is done or not done.

Thank you again for the opportunity to share these views.

Attachments:

The One-Page Form (“Basic Facts About Your Mortgage Loan”)

Washington Post editorial (“The Next Financial Crisis—How to Avoid It”)

THE BASIC FACTS ABOUT YOUR MORTGAGE LOAN

Borrower: _____ Property address: _____

Lender: _____

Amount of loan: \$ _____, which is _____ % of the property's appraised value.

Your loan is for _____ years.

The type of loan you have: _____

Your beginning interest rate is _____ %. This rate is good for _____ months/years. The rate and your payment can go higher on _____ and each _____ months after that.

Today's estimate of how high the rate will go, called the fully indexed rate, is _____ %.

The maximum possible rate on your loan is _____ %.

THIS LOAN IS BASED ON YOUR MONTHLY INCOME OF \$ _____.

Your beginning rate = a monthly loan payment of \$ _____ = _____ % of your income.
-including taxes and insurance this is about \$ _____ = _____ % of your income.

The fully-indexed rate = a loan payment of \$ _____ = _____ % of your income.
-including taxes and insurance this is about \$ _____ = _____ % of your income.*

*This is called your fully indexed housing expense ratio.

Special factors you must be aware of:

- A prepayment fee of _____ must be paid if _____.
- A "balloon payment" of \$ _____ to pay off your loan will be due on _____.
- You do/do not have a "payment option" loan. If you do, make sure you really understand what this means. Start with the definition on p. 3.

Total "points" plus estimated other costs and fees due at closing are \$ _____.

FOR QUESTIONS CONTACT: Name: _____

Phone: _____ e-mail: _____

See definitions of underlined terms and guidelines on pages 2-3.
DO NOT SIGN THIS IF YOU DON'T UNDERSTAND IT!

_____	_____	Borrower	_____	Date
Authorized Signer of Lender	Date	Borrower	_____	Date

The Basic Facts about Your Mortgage Loan

This form gives you the basic facts, but some mortgage forms may use terms not listed here. For a good, borrower-friendly information source, try the Mortgage Professor online (www.mtgprofessor.com), which includes detailed explanations of the technical mortgage terms in its glossary and much other helpful information.

Definitions and Guidelines Used in This Form

The *appraised value* is what a professional appraisal estimates the house could be sold for in today's market.

The *type of loan* determines whether and by how much your interest rate can increase. If it can, your monthly payments will also increase—sometimes by a lot. For example, in a thirty-year fixed rate loan, the interest rate is always the same. In a one-year ARM, it will change every year. Other kinds of loans have various patterns, but the interest rate may go up a lot. Make sure you understand what type of loan you're getting.

The *beginning interest rate* is the interest you are paying at the beginning of the loan. Especially if it is a low introductory or "teaser" rate, it is the rate which you will hear the most about from ads and salespeople. But how long is it good for and when will rates increase? In many types of loans, the rate will go up by a lot. You need to know.

The *fully-indexed rate* is an essential indicator of what will happen to your interest rate and your monthly payments. It is today's estimate of how high the interest rate on an adjustable rate mortgage will go. It is calculated by taking a defined "index rate" and adding a certain number of percentage points, called the "margin." For example, if your formula is the one-year Treasury rate plus 3 percent, and today the one-year Treasury rate is 5 percent, your fully-indexed rate is $5\% + 3\% = 8\%$. At the time the loan is being made, the fully indexed rate will *always* be higher than a beginning "teaser" rate.

The index rates are public, published rates, so you can study their history to see how much they change over

time. If the index rate stays the same as today, the rate on your loan will automatically rise to the fully-indexed rate over time. Since the index rate itself can go up and down, you cannot be sure what the future adjustable rate will be. In any case, you must *make sure you can afford the fully-indexed rate*, not just the beginning rate, which is often called a "teaser" rate for good reason.

The *maximum possible rate* is the highest your interest rate can go. Most loans with adjustable rates have a defined maximum rate or "lifetime cap." You need to think about what it would take to make your interest rate go this high. How likely do you think that is?

Your *monthly income* means your gross, pre-tax income per month for your household. This should be an amount which you can most probably sustain over many years. Make sure the monthly income shown on this form is correct!

Your *monthly payment including taxes and insurance* is the amount you must pay every month for interest, repayment of loan principal, house insurance premiums, and property taxes. Expressed as a percent of your monthly income, this is called your housing expense ratio. Over time, in addition to any possible increases in your interest rate and how fast you must repay principal, your insurance premiums and property taxes will tend to increase. Of course, your monthly income may also increase. How much do you expect it to?

Your *fully-indexed housing expense ratio* is a key measure of whether you can afford this loan. It is the percent of your monthly income it will take to pay interest at the fully-indexed rate, plus repayment of principal, house insurance, and property taxes. The time-tested market standard for this ratio is 28 percent; the greater your ratio is, the riskier the loan is for you.

A *prepayment fee* is an additional fee imposed by the lender if you pay your loan off early. Most

mortgages in America have no prepayment fee. If yours does, make sure you understand how it would work before you sign this form.

A “*balloon payment*” means that a large repayment of loan principal is due at the end of the loan. For example, a seven-year balloon means that the whole remaining loan principal, a very large amount, must be paid at the end of the seventh year. This almost always means that you have to get a new loan to make the balloon payment.

A “*payment option*” loan means that in the years immediately after securing a mortgage loan, you can pay even less than the interest you are being charged. The unpaid interest is added to your loan, so the amount you owe gets bigger. This is called “negative amortization.” The very low payments in early years create the risk of very large increases in your monthly payment later. Payment option loans are typically advertised using only the very low beginning or “teaser” required payment, which is less than the interest rate. You absolutely need to know four things: (1) How long is the beginning payment good for? (2) What happens then? (3) How much is added to my loan if I pay the minimum rate? (4) What is the fully-indexed rate?

“*Points*” are a fee the borrower pays the lender at closing, expressed as a percent of the loan. For example, two points mean you will pay an upfront fee equal to 2 percent of the loan. In addition, mortgages usually involve a number of *other costs and fees* which must be paid at closing.

Closing is when the loan is actually made and all the documents are signed.

The *For Questions Contact* section gives you the name, phone number, and e-mail address of someone specifically assigned by your lender to answer your questions and explain the complications of mortgage loans. Don’t be shy: contact this person if you have any questions.

Finally, *do not sign this form if you do not understand it*. You are committing yourself to pay large amounts of money over years to come and pledging your house as collateral so the lender can take it if you don’t pay. Ask questions until you are sure you know what your commitments really are and how they compare to your income. Until then, do not sign.

The Washington Post

AN INDEPENDENT NEWSPAPER

The Next Financial Crisis

How to avoid it

OVER THE past few years, hundreds of thousands of people with weak credit histories and inadequate income were sold adjustable-rate loans to buy houses they couldn't really afford. This was, it turns out, catastrophically unwise, because now those borrowers are defaulting in massive numbers and the resulting credit crunch threatens to drag down the entire U.S. economy. But amazingly none of this lending was illegal.

Undoubtedly some lenders broke laws and should be prosecuted by the appropriate state and federal authorities. But that will be a minority of the cases. Steering borrowers into subprime loans might have been ethically questionable, but it was not clearly against the law. And for every foreclosure today, there are some people sitting pretty even though they bought more house than they could afford — because they were lucky enough to refinance before home prices crashed.

That is why most of the legislative response to the crisis will necessarily operate prospectively. One of the most controversial features of many subprime loans is a heavy prepayment penalty. These make it all but impossible for borrowers to get out of disadvantageous subprime loans even after they discover that they could get better terms elsewhere. Probably a certain number of loans

could be made only if they included such provisions. However, such penalties introduce a measure of anti-competitive rigidity into the mortgage market and should probably be either capped or eliminated by federal law, as they are already in many states.

A great deal of the subprime misery could have been avoided if borrowers and lenders had been required to reach crystal-clear understandings in the first place. In June, the Federal Trade Commission released a survey showing that federal loan disclosure rules leave many borrowers confused. Only a third of borrowers could identify the interest rate of their loans; half did not know the loan amount; and two-thirds did not realize they faced a prepayment penalty. Banking expert Alex Pollock of the American Enterprise Institute proposes to close this information gap with a clear, one-page disclosure form that lists the basic terms of the loan in plain English, including the cost of taxes and insurance, followed by a last warning in capital letters: "DO NOT SIGN THIS IF YOU DON'T UNDERSTAND IT." Some lenders have already adopted the form voluntarily, and it is embodied in various bills percolating in Congress, with bipartisan support. To us, it seems like a clean, efficient way to protect borrowers, lenders and everyone else from the next sure thing in mortgage lending.